



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/23/07	Bill No:	AB 1617
Tax:	Cigarette and Tobacco Products	Author:	DeSaulnier
Related Bills:	SB 554 (Migden)		

This analysis will only address the bill's provisions that impact the Board.

BILL SUMMARY

Among other things, this bill would:

- Prohibit shipping or transporting cigarettes to persons in California, with certain exceptions, and
- Repeal the requirement that every retail sale of cigarettes in California be a vendor-assisted, face-to-face sale, unless specified conditions are met.

ANALYSIS

CURRENT LAW

Cigarette and Tobacco Products Tax Law

Under current law, Section 30101 of the Cigarette and Tobacco Products Tax Law imposes an excise tax of 6 mills (or 12 cents per package of 20) on each cigarette distributed. In addition, Section 30123 and 30131.2 impose a surtax of 12 ½ mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 ½ mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes. The surcharge rate for fiscal year 2006-07 is 46.76 percent.

Section 30101.7 provides, in part, that no person may engage in a retail sale of cigarettes in California unless the sale is a vendor-assisted, face-to-face sale.

A “face-to-face sale” is defined to mean a sale in which the purchaser is in the physical presence of the seller or the seller’s employee or agent at the time of the sale. A face-to-face sale does not include any transaction conducted by mail order, the Internet, telephone, or any other anonymous transaction method in which the buyer is not in the seller’s physical presence. However, this does not prohibit any lawful sale of a tobacco product that occurs by means of a vending machine.

Persons may engage in a non-face-to-face sale of cigarettes to a person in California provided that the seller complies with both of the following conditions:

The seller has fully complied with all of the requirements of Chapter 10A (commencing with Section 375) of Title 15 of the United States Code, otherwise known as the Jenkins Act.

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The seller has fully complied with either of the following requirements:

- All applicable California taxes on the cigarettes have been paid.
- The seller includes on the outside of the shipping container for any cigarettes shipped to a resident in California from any source in the United States an externally visible and easily legible notice located on the same side of the shipping container as the address to which the package is delivered stating as follows:

"IF THESE CIGARETTES HAVE BEEN SHIPPED TO YOU FROM A SELLER LOCATED OUTSIDE OF THE STATE IN WHICH YOU RESIDE, THE SELLER HAS REPORTED PURSUANT TO FEDERAL LAW THE SALE OF THESE CIGARETTES TO YOUR STATE TAX COLLECTION AGENCY, INCLUDING YOUR NAME AND ADDRESS. YOU ARE LEGALLY RESPONSIBLE FOR ALL APPLICABLE UNPAID STATE TAXES ON THESE CIGARETTES."

The Board is required to provide information relative to a seller's failure or attempt to comply with the Jenkins Act to the Attorney General. The Attorney General is required to provide an annual report to the Legislature regarding all actions taken to comply with, and enforce, the Jenkins Act.

The Attorney General or a city attorney, county counsel, or district attorney may bring a civil action to enforce the provisions of Section 30101.7 against any person that violates that section. In addition to any other remedies provided by law, the court is required to assess a civil penalty in accordance with the following schedule:

- A civil penalty of not less than one thousand dollars (\$1,000) and not more than two thousand dollars (\$2,000) for the first violation.
- A civil penalty of not less than two thousand five hundred dollars (\$2,500) and not more than three thousand five hundred dollars (\$3,500) for the second violation within a five-year period.
- A civil penalty of not less than four thousand dollars (\$4,000) and not more than five thousand dollars (\$5,000) for the third violation within a five-year period.
- A civil penalty of not less than five thousand five hundred dollars (\$5,500) and not more than six thousand five hundred dollars (\$6,500) for a fourth violation within a five-year period.
- A civil penalty of ten thousand dollars (\$10,000) for a fifth or subsequent violation within a five-year period.

Sales and Use Tax Law

Current law imposes a sales or use tax on the sale or purchase of tangible personal property in this state (including cigarettes and tobacco products). When a person sells cigarettes or tobacco products at retail in this state, the sales tax applies. The seller is responsible for this tax and must pay it to the state. When the sales tax does not apply, the use tax does. For example, when a person buys cigarettes from a point outside this state for the use or consumption in this state, the use tax is the applicable tax. If the out-of-state seller has nexus within the state, the seller is required to collect the use tax from the purchaser at the time of sale. If the seller does not collect the use tax, or if the seller does not have nexus in this state, the purchaser is required to pay the use tax directly to the Board. A purchaser will not be liable for the payment of use tax if receipts are obtained from a seller holding a seller's permit or a Certificate of Registration-Use Tax.

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Cigarette and Tobacco Products Licensing Act of 2003

Division 8.6 of the Business and Professions Code established the Cigarette and Tobacco Products Licensing Act of 2003 (Act). The Act established a statewide licensure program for the sales of cigarettes and tobacco products to address the unlawful distribution and untaxed sales of cigarettes and tobacco products.

In part, the Act requires a retailer to have in place and maintain a license to engage in the sale of cigarettes or tobacco products¹. Among other responsibilities, a retailer must conspicuously display its license at each retail location, keep complete and legible purchase invoices for cigarettes and tobacco products for four years, maintain cigarette and tobacco products invoices at each licensed location for at least one year after the date of purchase, and allow Board staff or law enforcement officers to review cigarette and tobacco products purchase invoices upon request.

The Act also imposes specified prohibitions and penalties in Business and Profession Code Sections 22980.1 through 22982. Among other prohibitions, the Act provides that a person engaging in the business of selling cigarettes or tobacco products in this state without a license or after a license is suspended or revoked is guilty of a misdemeanor punishable by a fine not to exceed five thousand dollars (\$5,000), or imprisonment not exceeding one year in a county jail, or both. Any violation of the Act by any person, except as otherwise provided, is a misdemeanor. Each offense is punished by a fine not to exceed five thousand dollars (\$5,000), or imprisonment not exceeding one year in a county jail, or both.

Federal Jenkins Act

Chapter 10A (commencing with Section 375) of Title 15 of the United States Code (otherwise known as the Jenkins Act) provides that any person that sells or transfers cigarettes for profit in interstate commerce, whereby such cigarettes are shipped into a state taxing the sale or use of cigarettes, to other than a distributor licensed by or located in such State, to file by the 10th of each calendar month a memorandum or a copy of the invoice for each and every shipment of cigarettes made during the previous calendar month in that state. This information is required to show the name and address of the person to whom the shipment was made, the brand, and quantity of the shipment. Any person who violates these provisions shall be guilty of a misdemeanor and shall be subject to a fine of not more than one thousand dollars (\$1,000), imprisoned not more than six months, or both.

STOP Tobacco Access to Kids Enforcement (STAKE) Act²

Under existing law, Section 22963 of the Business and Professions Code prohibits the distribution or sale of tobacco products directly or indirectly to any person under the age of 18 years through the United States Postal Service or through any other public or private postal or package delivery service at locations, including, but not limited to, public mailboxes and mailbox stores.

Any person selling or distributing tobacco products directly to a consumer in the state through the United States Postal Service or by any other public or private postal or package delivery service, including orders placed by mail, telephone, facsimile transmission, or the Internet, must verify that the purchaser is 18 years of age or older.

¹ Business and Professions Code §§ 22972 – 22974.8.

² Division 8.5 (commencing with Section 22950) of the Business and Professions Code

In addition, the seller or distributor is required to impose a two-carton minimum on each order of cigarettes, accept only personal check of the purchaser or the purchaser's credit card payments as payment for the purchase of any tobacco product, make a telephone call after 5 p.m. to the purchaser confirming the order prior to shipping the tobacco products, and deliver the tobacco product to the purchaser's verified billing address on the check or credit card used for payment.

A district attorney, city attorney, or the Attorney General is authorized to assess specified civil penalties against any person, firm, corporation, or other entity that distributes or sells tobacco products to a person under the age of 18 or does not comply with the requirements to sell or distribute tobacco products directly to a consumer in the state, as described.

PROPOSED LAW

This bill would repeal and add Business and Professions Code Section 22963 to make it unlawful for any person engaged in the business of selling or distributing cigarettes to ship or cause to be shipped any cigarettes to any person in this state who is not any of the following (hereafter "described person"):

- Licensed pursuant to Division 8.6 (commencing with Section 22970) of the Business and Professions Code.
- An export warehouse proprietor pursuant to Chapter 52 of the Internal Revenue Code (26 U.S.C. Sec. 5701 et seq.).
- An operator of a customs bonded warehouse pursuant to Section 1311 or 1555 of Title 19 of the United States Code.
- A person who is an officer, employee, or agent of the federal government, or of this state or of a department, agency, instrumentality, or political subdivision of the federal government or this state, when the person is acting in accordance with his or her official duties.

This bill would make it unlawful for any common or contract carrier to knowingly transport cigarettes to any person in this state reasonably believed by the carrier to be other than a described person.

It would also be unlawful for any other person to knowingly, or with reason to know, to transport more than 800 cigarettes at any one time to any person in this state, other than a described person.

This bill would impose a labeling requirement when a person engaged in the business of selling or distributing cigarettes ships or causes to be shipped any cigarettes to any person in this state, other than in the cigarette manufacturer's original container or wrapping. Such a container or wrapping would have to be plainly or visibly marked with the term "cigarettes."

This bill would also repeal Section 30101.7 of the Revenue and Taxation Code which prohibits a retail sale of cigarettes in California that is not a vendor-assisted, face-to-face sale, except under specified conditions.

Definitions. This bill would define "cigarette" to have the same meaning as in paragraph (3) of subdivision (a) of Section 30165.1 of the Revenue and Taxation Code and implementing regulations.

Enforcement. This bill would authorize the Board or a law enforcement agency to seize and take possession of cigarettes upon discovery of any cigarettes that have been, or are being, shipped or transported in violation of the shipping and transporting prohibition or labeling requirement. Any cigarettes seized by a law enforcement agency would be required to be delivered to the Board, or its designee, within seven days, unless the cigarettes will be destroyed by that law enforcement agency, or unless the cigarettes are otherwise required to be used as evidence in an administrative, criminal, or civil proceeding, or as part of an ongoing law enforcement operation.

Any cigarettes seized by the Board or delivered to the Board by a law enforcement agency would be deemed forfeited and the Board would be required to comply with seizure and forfeiture procedures as set forth in the Cigarette and Tobacco Products Tax Law.³

Penalties. A violation of the shipping and transporting prohibition or labeling requirement would be a misdemeanor and punishable as follows:

- Upon the first violation, a fine of not more than one thousand dollars (\$1,000).
- Upon the second violation, a fine of not more than five thousand dollars (\$5,000) and imprisonment not to exceed three months.
- Upon the third violation or subsequent violations, a fine of not more than twenty-five thousand dollars (\$25,000) and imprisonment not to exceed six months.

In addition to the criminal penalty, the Attorney General, district attorney, or city attorney would be authorized to bring a civil action against any person, firm, corporation, or other entity that violates this section. If a court determines that there has been a violation, the court would be required to assess civil penalties not to exceed five thousand dollars (\$5,000) per violation, plus the costs of investigating and prosecuting the action, including expert fees, reasonable attorney's fees, and court costs.

BACKGROUND

Senate Bill 1766 (Ch. 686, Stats. 2002, Ortiz) added Section 30101.7 to the Cigarette and Tobacco Products Tax Law to require, in part, that every retail sale of cigarettes in California be a vendor-assisted, face-to-face sale, unless all applicable taxes due on the sale are paid or the seller includes a prominent notice on the package indicating that the purchaser is responsible for any applicable California taxes on the cigarettes.

In 2002, SB 2082 (Bowen) would have required any person who advertises on the Internet to sell cigarettes in California, and who is subject to the provisions of the Jenkins Act, to conspicuously disclose that a purchaser who buys cigarettes shipped into California is responsible for paying the state excise tax and the state use tax and to show in the advertisement the amount of these taxes that would be due. This bill would have also required the person selling or transferring the cigarettes to provide to the Board a copy of the invoice for each shipment made into California. That bill failed to pass out of the Assembly Revenue and Taxation Committee.

In 2003, SB 1016 (Ch. 603, Bowen) added compliance with the Jenkins Act as a condition to allow a person to engage in a non-face-to-face sale of cigarettes to a person in California. That bill also requires the Board to provide information relative to a seller's failure or attempt to comply with the Jenkins Act to the Attorney General.

³ Chapter 7.5 (commencing with Section 30435) of Part 13 of Division 2 of the Revenue and Taxation Code.

In 2005, Assembly Bill 1029 (J. Horton) would have amended Section 30101.7 of the Cigarette and Tobacco Products Tax Law to revise the conditions under which a person may engage in a non-face-to-face sale of cigarettes to a person in California. However, the June 1, 2005, version of that measure deleted those provisions.

Last year, the Legislature passed SB 1208 (Ortiz), which is substantially similar to this bill. However, that measure was vetoed by the Governor. The Governor's veto message states the following:

"This bill would prohibit cigarette sales via the Internet to individual California consumers and only permit shipping of cigarettes via the Internet to state of California tobacco licensed businesses. Existing law reduces youth access to cigarettes over the Internet by requiring Internet sellers and shippers to verify the age of the purchaser, similar rules that apply to alcohol sales and shipments. In addition, the Board of Equalization is currently uses the federal Jenkins Act to recover excise taxes from Californians that have purchased cigarettes via out-of-state Internet websites."

IN GENERAL

Similar to the use tax, the collection of the cigarette and tobacco products excise tax relies heavily on the voluntary compliance of purchasers. However, due to the general misconception that purchases from outside this state are "tax free" and the insufficient resources to audit all purchasers, the voluntary compliance rate has been very low.

With respect to the number of cartons of cigarettes that are not being reported, the Board recently estimated cigarette excise tax revenues for out-of-state cigarette purchases to be \$53.9 million per year. However, that figure includes out-of-state purchases from all untaxed out-of-state sources, including the Internet, mail order, and cross border sales. The Jenkins Act only applies to Internet and mail order sales, which staff estimates to be 40 percent of the total amount of out-of-state sales. Therefore, it is estimated that approximately \$21.5 million ($\$53,900,000 \times .40 = \21.5) in cigarette tax or 2,478,161 ($\$21,560,000 / \$8.70 \text{ excise tax per carton} = 2,478,161$) cartons of cigarettes, are not being reported to the Board on an annual basis.⁴

In May 1999, the Board began a program to promote Jenkins Act compliance by out-of-state cigarette sellers. At the inception of the program, out-of-state sellers were reporting as many as 80,000 cartons in a single quarter. However, the number of cartons of cigarettes reported pursuant to the federal Jenkins Act significantly decreased beginning in 2001 due to the lack of enforcement at the federal level.

In April 2003, the Attorney General filed six lawsuits against six out-of-state tobacco retailers for selling cigarettes to minors via the Internet, failing to report tobacco sales to California tax authorities and depriving the state of excise taxes. The complaints alleged that the defendants violated California laws that govern payment of excise taxes on Internet cigarette sales, and federal statutes that require out-of-state sellers to report such sales to California tax agencies. Additionally, the lawsuits alleged the defendants wrongfully denied the state revenue. The defendants' failure to notify consumers of their obligation to pay taxes constitutes deceptive advertising, according to the complaints.

⁴ The number was not adjusted for cartons of cigarettes reported to the Board since that volume is deemed to be relatively insignificant to the estimated \$53.9 million per year in out-of-state purchases of cigarettes.

Five of these Internet tobacco retailers stipulated to entry of judgment against them. Each retailer and its principals agreed not to do business in California and to pay penalties, costs and attorneys' fees totaling more than \$1 million. A default judgment was entered against the other retailer for \$4.3 million. In addition, the largest two of these retailers agreed to file Jenkins Act reports with the Board dated back to January 1, 2000. These two companies reported about 400,000 shipments to California residents, and the Board is pursuing the collection of the excise and use tax from the California purchasers based on these shipments.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the Attorney General and is intended to facilitate the collection of taxes on cigarettes sold to residents of California over the Internet or by mail order. The bill is also intended to protect the public health of California residents and to prevent sales of cigarettes to minors over the Internet or by mail order.
2. **Suggested technical amendments.** For clarification purposes, the following amendments are suggested to proposed Business and Professions Code Section 22963:
 - Add a definition for the terms “distributing,” “selling” and “person.”
 - Change “board” to “Board of Equalization” throughout subdivision (d).

Board staff is available to work with the author's office in drafting these clarifying amendments.

3. **How is this bill different from the existing non-face-to-face ban?** Under existing law, a seller may make a non-face-to-face sale of cigarettes to a California consumer if certain conditions are met. This bill, however, would make it unlawful for a seller to ship cigarettes to any person in this state who is not a described person and for any common or contract carrier to knowingly transport cigarettes in this state reasonable believed by the carrier to be other than a described person.
4. **This bill is similar to a New York statute.** This bill is patterned after a New York statute (Public Health Law Section 1399-II), which prohibits direct shipment and transportation of cigarettes to consumers. The New York statute, however, contains a presumption that a common or contract carrier knew that a person was not a described person if cigarettes are transported to a home or residence.
5. **Additional efforts to curb direct cigarette shipments to consumers.** The Attorney General and Attorneys General from across the country, the federal Bureau of Alcohol, Tobacco, Firearms and Explosives and the major credit card companies agreed to work together to prevent the processing of payments for illegal Internet cigarette sales. Among other things, actions taken by some of the credit card companies include adopting policies to prohibit the use of credit cards for the illegal sale of cigarettes over the Internet, and agreeing to investigate and take action against any Internet sellers identified by law enforcement as using their credit cards for illegal online cigarette sales.

In addition, the state of New York has also negotiated agreements with UPS, DHL, and FedEx under which those companies have agreed to stop transporting cigarettes directly to individual consumers nationwide. Philip Morris USA (PM USA) also reached an agreement with a coalition of 37 Attorneys General to reduce the supply to PM USA cigarettes to those engaged in illegal sales of cigarettes.

6. **The Jenkins Act.** The Jenkins Act requires any person that sells or transfers cigarettes for profit in interstate commerce and ships the cigarettes into a state that imposes a tax on cigarettes to file by the 10th of each calendar month a copy of the invoice for each and every shipment of cigarettes made during the previous calendar month in that state. Many consumers who shop on the Internet may not be aware of these provisions and think they are successfully avoiding the tax by purchasing cigarettes from out-of-state sellers over the Internet. The Board utilizes the information required to be provided by the Jenkins Act to bill consumers for the taxes due. Unfortunately, most cigarette retailers do not comply with the provisions of the Jenkins Act. Since the Jenkins Act is a federal statute, the Board requires the assistance of federal law enforcement agencies to enforce its provisions. Also, the provisions apply only to the sale of cigarettes, not tobacco products.
7. **Internet purchases.** As efforts increase in this state to stop the illegal sale of cigarettes to minors, they may find it more difficult to purchase such products from traditional locations such as liquor stores and gas station mini-marts. This may lead to minors turning to the Internet as a means of acquiring cigarettes since the retailer is not likely to verify the age of the purchaser. This can lead to additional tax avoidance since the Internet retailer is unlikely to collect the California taxes and the minor purchasing cigarettes is unlikely to self-report the California taxes due.
8. **This measure would not apply to tobacco products.** The shipping and transporting prohibitions imposed by this bill would not apply to tobacco products. Tobacco products are defined to include, but not be limited to, all forms of cigars, smoking tobacco, chewing tobacco, snuff, and any other articles or products made of, or containing at least 50 percent, tobacco, but does not include cigarettes.

Board staff has recently estimated annual tobacco products evasion to be \$7 million in combined excise and sales and use taxes. To facilitate the collection of the tobacco products tax and related sales and use tax, consideration should be given to adding the shipping and transporting prohibition for tobacco products.
9. **Related legislation.** SB 554 (Migden) would revise the definition of "cigarette" for purposes of the Cigarette and Tobacco Products Tax Law.

COST ESTIMATE

The Board would incur costs to buy cigarettes for prosecuting violations and to seize and destroy cigarettes that are in violation of the shipping and transportation ban or labeling requirement. A detailed cost estimate is pending; however, the costs for last year's SB 1208 were estimated to be \$55,000 annually.

As an enforcement tool for the administration and collection of the cigarette tax, the Board's administrative costs related to this bill would be offset with cigarette tax revenues, which are deposited into the General Fund, Breast Cancer Fund, the Cigarette and Tobacco Products Surtax Fund, and California Children and Families Trust Fund.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

Under current law, out-of-state vendors may ship cigarettes or tobacco products to California homes or residences provided the vendor has paid all taxes or notified the consumer of their responsibility to pay all taxes, is in compliance with the federal Jenkins Act, and has met age of purchaser verification requirements. This bill, patterned after legislation enacted by the state of New York, prohibits shipping or transporting of cigarettes to persons other than a described person. According to the New York Attorney General, the New York shipping ban has greatly assisted their ability to reduce the volume of Internet and mail order cigarette sales shipped to homes or residences.

In 2006, we estimated that cigarette sales made by out-state Internet and mail order vendors directly to California consumers account for excise tax revenues of \$21.5 million per year.⁵ This estimate was made before the Board's Excise Taxes Division began a program to collect state excise and use taxes from California consumers who purchased untaxed cigarettes for their own use from out-of-state retailers. Based on data from the Excise Taxes Division, we estimate that compliance improvements resulting from this program reduce the \$21.5 million figure by about \$4.0 million, to \$17.5 million per year. We assume no additional voluntary compliance.

⁵ Source: "Documentation of Board of Equalization 2003 Cigarette Tax Revenue Evasion Estimates," 2/25/03. Based on the results of a California Department of Health Services (DHS) survey, we estimated that about 2 percent of cigarettes were purchased out-of-state by California consumers over the Internet or by mail order. Two percent of tax-paid distributions represented 24.7 million packs in fiscal year 2001-02. At a tax rate of \$0.87 per pack, excise tax revenue lost from Internet and mail order sales is \$21.5 million.

Updated data from a more recent DHS survey (*Tobacco Control Successes In California: A Focus on Young People, Results from the California Tobacco Surveys, 1990-2002*, October 2003) confirm the magnitude of the percentage of Internet and mail order purchases used to derive this estimate. Also, national data from the U.S. Census Bureau (*2002 Economic Census, Retail Trade, Subject Series*, October 2005) corroborate the magnitude of this percentage.

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Use tax revenues related to these \$17.5 million in Internet and mail order sales account for additional revenues of \$6.4 million. Excise and use tax revenues associated with Internet and mail order sales of cigarettes to consumers total \$23.9 million. The following table shows details of these revenues by fund.

Cigarette Tax Revenues From Internet and Mail Order Sales to Consumers		
	Tax Rate or Price	Millions
Distributions (Millions of Packs)	n.a	20.1
Excise Taxes	\$0.87	\$17.5
General Fund	\$0.10	\$2.0
Breast Cancer	\$0.02	\$0.4
Proposition 99	\$0.25	\$5.0
Proposition 10	\$0.50	\$10.1
Sales and Use Taxes		
Average Retail Price Per Pack	\$4.00	
Retail Value of Cigarette Sales	n.a	\$80.4
State		
General Fund	5.00%	\$4.0
Fiscal Recovery Fund	0.25%	\$0.2
Local	2.00%	\$1.6
Transit	0.69%	\$0.6
Totals		
Total Excise and Sales and Use Taxes		\$23.9
General Fund Excise and Sales Taxes a/	n.a.	\$6.0
a/ Included in above total.		
Totals may not sum due to rounding.		

Revenue Summary

The total potential combined excise tax and sales and use tax revenue gains from this bill could be as high as \$23.9 million if all sellers comply with the new law. Exactly how much depends on the degree to which out-of-state Internet and mail order sellers of cigarettes comply with the new law. Another unknown factor is the extent to which users of these products will decide to quit rather than to purchase the same products in physical “bricks and mortar” California stores.

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